September 30, 1994

Mitchell D. Reiver, Esq.
58-25 Queens Blvd.
Woodside, NY 11377

Re: Business Lending Rule -- Associated Members
(Letter of August 1,1994)

Dear Mr. Reiver:

You request a legal opinion regarding whether all shareholders of a state-chartered corporation are to be deemed "associated members" for purposes of NCUA's business lending rule, when the underlying security for credit union loans to such shareholder-borrowers are shares ofthe corporation's stock. 12 C.F.R. §701.21(h)(1)(iii). Underthe facts presented, such shareholders are considered "associated members" under the business lending rule.

BACKGROUND

Montauk Credit Union has made several loans to members secured by shares of stock in Skyline Credit-Ride, Inc. ("SCRI"), a not-for-profit membership corporation organized, among other things, to dispatch calls to individual livery owners via a two-way radio dispatch system. Each individual owner becomes a shareholder of SCRI and receives a stock certificate evidencing the ownership interest. Income is generally determined by the number of hours radios on the system are operated.

ANALYSIS

An "associated member" is defined as:

> any member with a shared ownership, investment or other pecuniary interest in a business or commercial endeavor with the borrower.

12 C.F.R. §701.21(h)(1)(iii). When the term "associated member" was proposed in 1986, the Board stated:

> Section 706.1(c) describes a member who, along with other members, borrows funds from a FICU [federally insured credit union] where each member has a common ownership, investment or other pecuniary interest in a business or commercial endeavor. In singling out these members, the Board is attempting to properly ascribe the ultimate beneficiary (e.g.,

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> the common business enterprise) of the loans obtained from the credit union and sufficiently allocate the total exposure that a FICU may have when making loans to one or more associated members. It is not uncommon to see members individually obtain loans for the same business venture, with each member assigning (transferring, investing, etc.) the proceeds of the loan to the business. In almost all instances, repayment is directly tied to the success of the business and its ability to repay the loan(s). In order to properly aggregate the total exposure that a group of such loans poses to a FICU, and for purposes of the limitation (§706.6) provisions of the proposed rule, the Board has created and defined the term "associated member."

Proposed Rule, 51 Fed. Reg. 23234, 23235 (June 26, 1986). The meaning of the term "associated member" is further clarified in the 1991 final amendment to the business loan rule.

> Section 701.21(h)(1)(iii) defines the term "associated member." Several commenters requested clarification that the term be limited to shared interests with this credit union. Although no change is being made to the final rule, it is noted that the Board intends for this term to be limited to shared interests, investments or other pecuniary interests associated with the credit union where the loan has been requested.

Final Rule, 56 Fed. Reg. 48421, 48422 (September25, 1991).

Read together, the preamble portions regarding the definition of "associated member" indicate that the key to determining whether a group of loans is tied to a single "business" or "commercial" venture is the credit union's exposure. The business loan rule's use of the terms "business" or "commercial" venture demonstrates an interest not to be bound by legal formalities; a credit union must look to commercial reality. In other words, in order for "associated membership" in a business or commercial venture to occur, NCUA must show that the failure of the underlying security for one loan would be directly tied to the underlying security for the other loans proposed to be aggregated with the loan being reviewed.

In this case, regarding loans with shares of stock as security, the "associated membership" test is met. If SCRI fails, its shareholders will not be considered creditors of the corporation with a claim on the company's remaining assets, but instead are considered to be equity owners to be paid only if anything remains after all other claims are paid. 9 Am.Jur. 2d Bankruptcy, §§363, 381-384 (1991). Risk and exposure are

greater in small, undiversified, closely-held corporations. Federally insured credit unions need to be cognizant of this risk and exposure; if safety and soundness grounds are met, the Regional Director can approve higher loan to one borrower limits. 12 C.F.R. §701.21(h)(2)(iii)(A).

With this in mind, the Region was correct in aggregating all members with livery loans secured by shares of Skyline Credit-Ride, Inc. as "associated members" for purposes of the business loan rule.

Sincerely,

Richard S. Schulman
Associate General Counsel

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